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TIGHT CREDIT

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TIGHT CREDIT

PUBLIC CONTROVERSY over shortages of credit and high costs of borrowing has prepared the way for sharp debates at the 1957 session of Congress on monetary policies of the Federal Reserve Board and the Eisenhower administration. Official insistence upon keeping credit tight has brought heated attack—as well as solid defense—in recent months from financial experts, business leaders, state-local executives, and ordinary citizens. The prospective chairman of the congressional Joint Economic Committee, Rep. Wright Patman (D-Tex.), warned in December that unless current restrictions were relaxed Congress might well adopt special legislation to make credit more readily available.[1] The impact of tight credit on the housing industry already has brought promises of early investigations by the House Veterans Affairs Committee and the Senate Banking and Currency Committee.

The so-called tight money policy has led not only to questioning of the wisdom of recent Federal Reserve actions, but also to expressions of doubt as to the effectiveness of monetary devices in moderating booms and braking recessions. The wide range of the present controversy has prompted suggestions from financial leaders that the time is ripe for creation of a special commission to study and report to the President and to Congress on proper uses of monetary policy in governmental efforts to maintain economic stability.

Hardships Resulting from Credit Restriction

Opponents of the policy of credit restraint contend that it has benefited lending institutions and large corporations while working needless hardship on small businesses, states and localities, and consumers. Some corporation execu-

[1] Patman said, Dec. 11: "The Federal Reserve Board seceded from the [Truman] administration in 1951, but it can't secede from Congress. Congress will take action in the foreseeable future if the Federal Reserve doesn't change present trends that are proving disastrous to the economy." For 1951 incident, see pp. 16-18.

tives have accused the Federal Reserve of hamstringing the expansion plans of important industries. Other critics have asserted that Federal Reserve actions are setting the stage for near-future recession. Rep. Patman said, Dec. 9, that far from preventing inflation, as intended, the tight money policy was actually promoting a rise in prices. Sen. Joseph C. O'Mahoney (D-Wyo.) agreed that Federal Reserve policy had been inflationary because the resulting higher interest rates were being reflected in higher costs for consumer goods.[2]

Elliott Bell, publisher of *Business Week* and a noted financial authority, stated at a hearing of a Joint Economic subcommittee, Dec. 10, that "Although the Federal Reserve has been following a stringent credit policy for well over a year, and has prevented virtually any expansion of the money supply, bank loans have expanded to record levels." [3] Higher interest rates, Bell said, had presented "no serious obstacle to large and profitable corporations." He noted that "Since interest paid is a tax-deductible expense, a prime rate of 4 per cent costs the corporate borrower less than 2 per cent," and that even a rate of 8 or 9 per cent "would cost the large corporation after taxes less than municipalities are now paying for money to build schools."

> The tight money policy [Bell continued] thus far has hurt home builders, small business, and municipalities that need to build schools and other improvements. It may actually have stimulated, rather than curbed, business borrowing because the prudent corporation executive, reading and hearing about tight money policies, has in many cases borrowed money he did not yet need—just to be on the safe side.

At the same time Bell conceded that tight money "may grab hold very soon now because financial institutions have come about to the end of the road when it comes to selling 'governments' . . . [and] many banks are 'loaned up' to the limit of what they consider prudent."

Some slackening in the use of credit has become apparent in recent months. A number of large corporations, including General Electric and General Motors, have

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[2] The Federal Reserve Board reported at the end of November that higher wage rates, increased costs of commodities, and other factors had pushed consumer prices up 2 per cent since early 1956 and industrial prices up 7 per cent since mid-1955.

[3] Between Jan. 1, 1955, and Oct. 31, 1956, latest date for which such figures are available, outstanding loans of commercial banks zoomed more than $18 billion—from $70.6 billion to an estimated $88.8 billion.

slowed down or postponed plant expansion. Business loans made by banks showed a smaller gain in the second half of 1956 than in the like period a year earlier. And repayments on automobile instalment debt began last autumn to exceed new borrowing for the first time in two years.

Defense of Tight Credit to Counter Inflation

Defenders of the current policy maintain that it has been necessary to keep credit tight in order to prevent inflation, which they insist, is still the nation's No. 1 domestic problem. Chairman William McC. Martin, Jr., of the Federal Reserve Board pointed out Dec. 11 that, with the economy already operating near capacity and prices already going up, supplying all the easy credit desired would have "increased inflationary bidding for available resources, especially in the sectors of capital equipment and construction."

The best known way to help stay inflation, Secretary of the Treasury Humphrey told the Detroit Economic Club last Oct. 8, is use of "a flexible price for money" because it is "a governor that operates to hold down the cost of living." Humphrey said that there might be differences of opinion as to timing and degree, but that the process of using the price of money as an economic regulator was "a sound, right step in the direction of sound money . . . [and] a sound economy." According to Under Secretary of the Treasury W. Randolph Burgess, tight money, far from hurting the overall economy, was having "a wholesome effect." [4]

In testimony before the Joint Economic subcommittee, Dec. 11, Chairman Martin admitted that despite attempts to limit inflationary pressures, prices had risen far more than he would have liked, but he maintained that they would have gone much higher "if the law of supply and demand hadn't been allowed to dampen excessive demands for credit." Answering criticism that higher interest rates had hampered construction of schools, Martin said that it was more desirable to have such building delayed than, with supplies and labor scarce, to have school districts "rush in, grab for steel, push prices up, and pay more for labor and materials than they were worth."

[4] Statement at press conference following meeting of Business Advisory Council, Sea Island, Ga., Nov. 10, 1956.

Scarcity of Credit In Peacetime Prosperity

THE UNITED STATES, land of plenty, finds itself plagued by an insufficiency of credit for the first time since the depression decade of the 1930s. Record-breaking demands by borrowers—commercial and industrial firms, state and local governments, buyers on instalments—are pressing against the limits of the country's available credit resources. Whether the present shortage is due to a deficiency of supply or an excess of demand—both of which arguments are heard—there is no denying that not all borrowers can get all the credit they want, when they want it, at the price they would like to pay for it.

Interest rates have risen to their highest levels in more than two decades and are expected to keep on climbing. The Federal Reserve discount rate, the rate paid by member banks on borrowings from the Reserve banks, now stands at 3 per cent, the highest it has been in 23 years. The rate has been upped six times since April 1955.[5] Costs of both short-term and long-term Treasury borrowing have zoomed; recent issues of 91-day bills have sold at a price equal to an average yield of around 3.3 per cent, highest since the bank holiday of 1933, and several issues of long-term bonds sold in December at prices to yield about 3.5 per cent.[6] Top-grade public utility bonds have sold recently at net interest costs of 4.34 per cent, the highest for securities of comparable quality since 1935.

The cost of credit, though of first concern to immediate lenders and borrowers, eventually is felt by most other individuals as well; in the long run, no one escapes the impact of tight money. As Rep. Patman pointed out at a hearing last June before the Joint Economic subcommittee he heads, "The workings of monetary policy, through its effect upon interest rates and the availability of credit, intimately affect the lives and fortunes of every business, . . . homeowner, . . . farmer, and . . . citizen." Tight credit

[5] It has been reported that a seventh hike in the discount rate, which had been anticipated after last November's election, was called off, at least for the time being, when the Middle East crisis caused postponement of some business expansion, but in mid-December reports were heard that the Federal Reserve was again considering a further increase.

[6] Cost of servicing the national debt rose from $6.4 billion in fiscal 1955 to $6.9 billion in fiscal 1956, and for the year ending next June 30 is estimated to reach $7.1 billion, an increase of $700 million in two years.

has had an especially severe impact upon the housing industry, small business establishments, and local governments.

EFFECTS OF CREDIT STRINGENCY ON HOME BUILDING

Albert Cole, administrator of the Housing and Home Finance Agency, told a Des Moines audience last November that home building was "down all across the nation because there has not been enough money to finance all the houses that American families want and can afford to buy." According to a joint Commerce-Labor Department report issued Nov. 20, housing starts dropped from 1.3 million in 1955 to 1.1 million last year and are likely to fall to 1 million in 1957.[7] Rising interest rates have made lenders reluctant to grant loans on government-guaranteed home mortgages. Homes built under the G.I. loan program, which have been accounting for about one-quarter of all private housing starts, totaled only 17,824 in November, off more than 10,000 from November 1955.

With the interest rate on home mortgages up to a national average of about 5½ per cent, the federal government, in an effort to make more mortgage money available, on Dec. 4 lifted the interest rate on loans insured by the Federal Housing Administration from 4½ per cent to 5 per cent. Although expected to provide some limited aid in the F.H.A. market, the more profitable rate made it virtually impossible for ex-G.I.'s to obtain mortgages guaranteed by the Veterans Administration because interest on those loans is limited by law to a maximum of 4½ per cent. Federal housing officials have indicated on several recent occasions that Congress would be asked shortly after it reconvened to increase the rate on G.I. loans.

The Veterans Administration has expressed opposition to any boost in the 4½ per cent rate, and there have been signs that it can expect some support in Congress. Rep. Olin E. Teague (D-Tex.), chairman of the House Veterans Affairs Committee, announced on Dec. 8 that he planned hearings in January to make a "complete reappraisal" of the G.I. housing programs, and he expressed the opinion that a higher interest rate would "not solve the glaring inequity in the availability of mortgage financing for veterans' loans." Both Teague and Sen. Hubert H. Humphrey

[7] Work was started on only 79,600 private houses in November, the lowest number for that month since 1951.

(D-Minn.) have urged that, rather than raise interest rates, the Veterans Administration step up the program under which—in designated rural areas—it can lend money directly if it determines that private mortgage funds are not available.[8]

IMPACT ON SMALL BUSINESS AND PUBLIC CONSTRUCTION

Tight credit conditions have made it increasingly difficult for small businesses to obtain needed loans. Small firms rely chiefly on commercial banks for credit, and when credit becomes scarce generally, many banks lose interest in lending to such borrowers. A survey of 127 banks and 727 manufacturing enterprises, made last spring by the Standard Factors Corporation of New York, disclosed that while 53 per cent of the firms with assets of less than $25,000 had bank lines of credit in March 1955 only 18 per cent had them a year later. On the other hand, among concerns worth more than $2.5 million, 99 per cent had all the credit they needed on both dates. As a result of financing and other difficulties, many small businesses have folded. According to Dun & Bradstreet, business failures in the first ten months of 1956 averaged over a thousand a month, the highest rate since 1940, and most of the bankruptcies were of small concerns.

To ease the credit squeeze on small enterprises, the Small Business Administration has moved to get a larger volume of government orders set aside for exclusive award to small firms. And it has given its regional offices authority to approve certain loans, up to a limit of $100,000, without Washington's consent. Congress is expected at the 1957 session to increase the S.B.A. revolving fund for lending to small companies.

Increased costs of borrowing have caused state and local governments either to pay unexpectedly high interest rates or to postpone—or even cancel altogether—the construction of school buildings, highways, and other public improvements. The *Wall Street Journal* reported, Nov. 26, that "Local governments are being forced to pay the highest interest rates in over 17 years for their borrowings." New York State Comptroller Arthur Levitt testified before the

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[8] The likelihood that Congress will raise the interest rate seemed to be recognized, however, by the Veterans Administration when it announced, Dec. 14, that lenders would be allowed to stipulate that any loans currently being negotiated shall bear the highest rate permissible when the transaction is completed.

Patman subcommittee on Dec. 10 that between last June and November the average interest rate on borrowings to finance school construction in New York had risen from 2.760 per cent to 4.078 per cent. According to the Investment Bankers Association, the tight money market influenced various public agencies to postpone or cancel approximately $350 million of projected construction during the third quarter of 1956.

Comptroller Levitt asked federal action to encourage the flow of funds to the municipal bond market. He suggested amendment of the Internal Revenue Code to permit investment companies buying state-municipal securities to receive the interest earned tax free. He urged also that the Federal Reserve System require its member banks to hold a certain proportion of their reserves in municipal bonds and that federal savings and loan associations be allowed to invest in such securities.

Factors Behind Insufficiency of Lendable Funds

The main reason credit is scarce and expensive is that there just isn't enough of it to go around. Almost everybody—individuals, companies, and governments—wants to borrow. As C. Canby Balderston, vice chairman of the Federal Reserve Board, has put it: "Too many people want too many things too fast. They want to build new plants, office buildings, ships, and planes at an unheard of rate and still retain record rates of production for residences and autos."[9] The resultant pyramiding of demand, Balderston said, had created shortages not only of steel, cement, and skilled labor, but also of credit. Like everything else, money becomes more costly as demand rises.

The unprecedented volume of borrowing is a concomitant of the unparalleled volume of economic activity. The gross national product—dollar measurement of the national output of goods and services—has risen to an all-time high annual rate of $414 billion. The tremendous expansion of population (4 million children were born last year, as compared with an average of 2.5 million a year during the 1930s) has created a need for more houses, schools, churches, public utilities, and goods of all kinds. Individuals, earning more than ever before (personal income

[9] Address at University of Pennsylvania, Philadelphia, Oct. 12, 1956.

has been running at a record annual rate of around $333 billion), have wanted to buy more and better things.

Industry has been turning out products in record quantities; the Federal Reserve Board's index of industrial production, which measures output of factories, mills, and mines, has reached 147 per cent of its 1947-49 level. Vast expansion programs have been undertaken; expenditures for new plant and equipment totaled a record $35 billion in 1956,[10] and it is estimated that they may hit a new high of $40 billion this year. Public works programs have been launched by all levels of government.

All this fevered activity has called for more credit than ever before in peacetime, and, as F.R.B. Chairman Martin testified, Dec. 11, "The combined demand for funds . . . from virtually all sectors of the economy . . . has outrun the available supply." He explained further: "Although the so-called 'tightness' of credit is often attributed to an insufficient supply of money, the fact is that the tightness results from the volume and intensity of demand."

Shortage of Savings as Cause of Credit Tightness

The "real reason" money is expensive and less readily available, according to Treasury Under Secretary Burgess, is that the demand "is in excess of the amount . . . people are saving."[11] Under the free enterprise system, savings—as represented by the money put into savings accounts of various kinds, pension funds, insurance, securities, etc.—are relied upon to satisfy the bulk of the demand for credit, and they have not expanded as much or as fast as the demand for loans.

In a talk before the Detroit Economic Club last Oct. 8 Secretary Humphrey gave this explanation of the deficiency in savings: "We have been through a period . . . when there was little incentive to save. In the first place, the interest rate was held down so low that there was very little return. . . . In the second place, as the value of the dollar declined and as inflationary pressures took hold, people were afraid to save a dollar because it was constantly declining in value."

[10] "In 1955 it was individual borrowing to buy homes and cars that overstrained the credit supply. . . . [In 1956] business borrowings, to cover record plant and equipment programs, have been the central feature."—First National City Bank (of New York), *Business and Economic Conditions* (monthly letter, September 1956), p. 100.

[11] Address before Life Insurance Association of America, New York, Dec. 13, 1956.

While individuals are now saving at one of the highest rates in U.S. history (personal saving rose from an annual rate of $16.6 billion in 1955 to $21.4 billion toward the end of 1956, a rate surpassed only during the Korean war), they still are not saving enough to meet all demands for loans. And the Treasury reported, Dec. 12, that investors cashed in more savings bonds than they bought in November, the fifth month of 1956 in which redemptions had exceeded sales.

To encourage more saving, the Federal Reserve Board and the Federal Deposit Insurance Corporation early last month authorized insured commercial banks to increase their interest rates on savings deposits from 2½ per cent to 3 per cent, effective Jan. 1. At the same time the F.R.B. and the F.D.I.C. authorized a one-half per cent boost in the interest paid on time deposits, mainly deposits made by business enterprises. Large and small banks all across the country immediately announced that they would raise their interest rates on both savings accounts and time deposits at the beginning of the new year.

Reasoning Underlying Restraints on Credit Boom

Monetary authorities direct attention to the fact that in the present period of high prosperity, despite record-breaking output, the demand for goods and services is greater than the supply of commodities and manpower. Under such circumstances, Chairman Martin said Dec. 11, creating more money would not create more goods. "It can only intensify demands for the current supply of labor and materials."

Speaking before the National Press Club in Washington last May 24, Secretary Humphrey spelled out the same idea in greater detail: "When you are in a period of . . . very high business activity, if you try to move up to any great extent from that extremely high level, you soon reach the place where there are not enough more materials . . . and . . . people . . . to make many more goods. If the pressure is pushed too high . . . , you get a scramble for materials and . . . people and you raise costs to the . . . public . . . without giving . . . [it] anything more or better."

Martin observed on Dec. 11 that, as the economy moved from the downturn of 1953 and 1954 to recovery

and boom in 1955 and 1956, and "in general pressed against the limits of immediate capacity," the central bank took steps to "keep expansion of credit within the limits of the growth in resources." Such restraint was necessary, he said, to "discourage excesses that would inevitably produce higher prices and severe economic maladjustments."

Federal Reserve authorities have been particularly concerned about the fact that some corporations, having found bond-financing costs higher than they liked, were resorting to bank loans to carry out plant-expansion programs. Federal monetary authorities hold that bank loans should be used primarily for short-term purposes, such as filling inventory needs. Financing plant expansion out of savings or retained earnings was completely unobjectionable, Martin testified last June, but financing construction by bank credit, "particularly . . . short-term credit," might well lead to "a bust."

What the Federal Reserve has been trying to do, the newsletter of a leading bank has explained, is "skim the froth off the boom and hold credit expansion within limits consistent with a stable economy." The Federal Reserve "has no authority to deny people their right to spend their own money as they please," the newsletter continued, but it does "have the right . . . to discourage borrowings that rest in the final analysis on extensions of credit by the . . . Reserve banks." [12]

Other observers have pointed out that it is not so much that the Fed has tightened credit as that it has permitted credit to tighten by itself by not making a larger supply available. In the words of a report made last November by an Investment Bankers Association committee: "The Federal Reserve did not make 'tight money.' Rather, . . . [it] refused to close with inflationary dollars the gap between savings and the demand for capital."

[12] First National City Bank (of New York), *Business and Economic Conditions* (monthly letter, October 1956), p. 111.

Control of Credit Supply by Federal Reserve

ESTABLISHED in 1913 primarily to provide an "elastic currency," the Federal Reserve System long since assumed the much broader function of assuring a flow of money and credit that will foster orderly economic growth and at the same time maintain a stable dollar. Its broader purpose was given added significance by adoption of the Employment Act of 1946, which declared that it was "the continuing policy and responsibility of the federal government . . . to use all practicable means . . . to promote maximum employment, production, and purchasing power." Fiscal and monetary policies are among the major means for achieving those ends. While Congress and the Treasury are responsible for fiscal policy, the Federal Reserve, a creature of Congress, has been assigned the responsibility for monetary policy.

By acting to ease or to tighten credit, the Federal Reserve attempts to counteract both inflationary and deflationary tendencies—it "leans against the breeze," as Chairman Martin has put it.

> The task of the Federal Reserve System, under today's conditions [Martin told the Patman subcommittee, Dec. 11] is to determine the volume of credit that needs to be made available in order to keep the economy running in high gear—but without over-strain. Too much credit would intensify upward pressures on prices. Too little could needlessly starve some activities.
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> We have to rely on human judgments in this determination. There are bound to be differences in judgment. . . . We do not undertake—and I do not see how it could be otherwise, short of some form of dictatorship—to say how a given supply of credit shall be allocated.[13]

What the Federal Reserve does do, is to affect, by its operations, the ability of banks to meet applications for credit. Banks can extend credit only in proportion to the reserves at their disposal, and banks with membership in the Federal Reserve System[14] are required to keep on

[13] While it is the "responsibility of the central bank to influence the total supply of credit," Vice Chairman Balderston of the Federal Reserve Board has observed, "the selection of the particular customers to whom loans are to be made is left to the discretion of commercial bankers and other private lenders."—Address at University of Pennsylvania, Philadelphia, Oct. 12, 1956.

[14] As of Dec. 31, 1955, latest date for which such figures are available, 6,543 of the nation's 14,243 banks, holding 85 per cent of all commercial bank deposits, were members of the system.

deposit with the district Reserve banks cash equal to a specified percentage of their total deposits. By influencing the availability and cost of additional reserves, the Fed can affect the amount of credit that banks can extend to the public and ultimately the total flow of money and credit in the country.[15]

PRINCIPAL RESERVE METHODS OF REGULATING CREDIT

The Federal Reserve uses three principal methods to regulate bank reserves and thereby expand or contract the volume of credit to meet fluctuating needs of the economy. They are: Changing the discount rate, conducting open market operations, and altering reserve requirements.

The *discount rate* is the interest rate charged member banks by the Federal Reserve banks for money they borrow to replenish their reserves. The privilege of borrowing is intended to serve only temporary needs for reserve funds and not long-term needs related to growth of the economy. When a member bank obtains such a loan, the district Reserve bank enters a credit in its reserve account equal to the amount of the accommodation.

Raising the discount rate makes borrowing to replenish or increase reserves more expensive for commercial banks and ultimately makes credit more expensive for the public because the commercial banks in turn increase the interest rates on loans extended by them. When the Fed believes that the volume of credit is expanding too rapidly, it raises the discount rate thus tending to restrict the supply. When it feels that an expansion should be encouraged in the public interest, it reduces the rate.

Since the end of World War II, the discount rate has risen from 1 per cent to 3 per cent. After having been advanced to 2 per cent in early 1953, the rate was lowered to 1¾ per cent and then to 1½ per cent the following year, when it became apparent that the restrictive monetary policy had been more potent than expected. In late 1954 the Federal Reserve shifted from a policy of "active ease" to one of moderate restraint, and in April 1955 it hiked

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[15] "The Federal Reserve, by adding to or extinguishing the member bank's reserves, can influence it to increase or decrease its loans and its demand deposits by several times the amount added or extinguished. It is because of this fact that Federal Reserve dollars are often called 'high-powered' dollars as compared with ordinary deposit dollars."—Federal Reserve Board, *The Federal Reserve System—Purposes and Functions* (1954), p. 20. For details on how a dollar of reserves can be made to support around six dollars of loans, see "Credit Control in Inflation," *E.R.R.*, Vol. I 1951, p. 28.

the rate back up to $1\frac{3}{4}$ per cent. Since then the rate has been advanced by stages to its present level of 3 per cent.

Open market operations consist of large-scale Federal Reserve purchases and sales of government securities. Unlike discount operations, which are initiated by the member banks, open market operations are initiated by the Fed. The buying and selling are supervised by the Federal Open Market Committee, which is composed of eight permanent members (the seven governors of the Federal Reserve System and the president of the New York Federal Reserve Bank) and four rotating members (presidents of four of the 12 Reserve banks).

All commercial banks, other financial institutions, and many large corporations have the bulk of their operating or secondary reserve funds invested in government securities. By buying "governments" the Fed increases the ability of banks to make loans because the purchase creates a credit with the Federal Reserve. By selling them, it decreases the volume of lendable funds inasmuch as the securities are paid for out of the reserve accounts of commercial banks. During November and December the Federal Reserve, making purchases almost every week, bought about $1 billion worth of government securities in order to ease the pressure on bank reserves during the pre-Christmas season.

Changes in *reserve requirements* directly affect the amount of funds available to commercial banks for lending. By law, member banks are required to keep a certain percentage of their deposits in reserve. The Federal Reserve Act prescribed that for banks in central reserve cities (New York and Chicago) the percentage of demand deposits must be at least 13 per cent; for those in the other reserve cities, at least 10 per cent; and for all other member (country) banks, at least 7 per cent. In 1935 the Federal Reserve Board was given authority to increase reserve requirements to as much as twice the ratios stated in the law; since mid-1954 the requirements have stood at 20 per cent, 18 per cent, and 12 per cent for the three classes of banks, respectively.

By increasing reserve requirements, the Fed can restrict loans. If reserves do not come up to the required percentage

of deposits, banks must curtail lending. Changes in reserve requirements are a blunt and potent instrument because they affect all member banks subject to the action at the same time and to the same extent. Experience has shown, however, that this instrument is not adapted to daily changes in monetary conditions, and it has not been used frequently. For day-to-day operations to influence the flow of credit, the Federal Reserve depends principally on the more flexible instruments of discount and open market operations.[16] All three devices, Chairman Martin has said, "must operate together—in a continuing pattern, the supply of reserves always being basic."

SUBSERVIENCE TO TREASURY IN EARLY POSTWAR PERIOD

The Federal Reserve System's use of its credit control instruments to keep money tight during the past two years has been in marked contrast to its actions in the first five years after the war. In that period the Truman administration wanted interest rates kept low to enable the federal government to borrow as cheaply as possible and to preserve the market value of government securities in the hands of the public. Under that general policy the Federal Reserve, in agreement with the Treasury, supported the price of "governments" by offering to buy all such obligations at fixed prices. "In view of the recurrent heavy demands for funds during the period, these purchases had the effect of monetizing substantial amounts of government securities, creating bank reserves, and laying the basis for excessive credit expansion." [17]

In those circumstances, the Federal Reserve's credit control devices were rendered largely ineffective. Changes in the discount rate had little effect because banks could sell government securities to the Fed rather than borrow funds from it to maintain their reserves at proper levels. Open market operations were deprived of their potency because, with government bond prices pegged, banks could be sure of selling their securities, to obtain cash for lending, without taking a loss. No further pressure could be exerted through changes in reserve requirements because those requirements already had been raised to the limits allowed by

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[16] Federal Reserve Board, *The Federal Reserve System—Purposes and Functions* (1954), pp. 50-52.

[17] F.R.B. Chairman Martin in Joint Economic Committee, *Monetary Policy and Management of the Public Debt* (1952), p. 345.

law. The result was that private borrowing, demand deposits, and consumer prices all rose sharply.

Differences between the Federal Reserve and the Treasury on how to achieve the objectives of maintaining a healthy market for government securities and at the same time restraining expansion of bank credit were intensified by the inflationary pressures that followed the Korean outbreak in mid-1950. The dispute resulting from the Treasury's insistence that the Federal Reserve continue to support prices of government securities and the Fed's desire to maintain a stable currency was carried eventually to the White House and to Congress.

INDEPENDENCE OF OPERATIONS SINCE ACCORD OF 1951

The controversy reached the boiling point after Secretary of the Treasury John W. Snyder indicated in an address at New York, Jan. 18, 1951, that the Treasury intended to continue financing its requirements at the pegged rates then in effect. Continued Fed-Treasury disagreement led to a White House conference on Jan. 31, and when that failed to produce a settlement, the dispute was taken to Congress.

Addressing the Senate on Feb. 22, Sen. Paul Douglas (D-Ill.), a trained economist, urged that the Federal Reserve be freed from Treasury influence. He termed the practice of having the Fed make unlimited bond purchases "the prime cause of inflation."

> We all have good reason to believe [Douglas continued] that while the Federal Reserve has done this guilty thing, it has done so protestingly and unwillingly. It has wanted to lead a virtuous life. But over . . . [its] shoulder . . . has stood the Treasury, making threatening . . . gestures and . . . cracking its whip. . . . [The Treasury has] insisted that the Reserve System . . . buy every government security which is offered. . . .
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> Whenever the Federal Reserve . . . has been reluctant to go along on this unlimited program of bond and security purchases, the Treasury has resorted to a strategy of mixed cajolery and threats. . . . The Reserve Board has been told that it should cooperate, that it should stand by the President and not rock the boat. It has been told that if the price of government bonds falls or the interest rate rises, the Reserve Board will be held responsible. . . .
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> It is intimated that if the . . . Board is recalcitrant, the . . . system will be nationalized, and all independence will be taken away. . . . Under this pressure the Federal Reserve System has gone alone. The real responsibility has been that of the Treasury.

The Treasury has pulled the strings, and the Federal Reserve has danced to its music.

Toward the end of February, President Truman reiterated his support of the basic Treasury position and ordered the disputants to come to some kind of agreement at once. On Mar. 4, the Secretary of the Treasury and the Chairman of the Federal Reserve Board announced jointly that they had "reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the government's requirements and, at the same time, to minimize monetization of the public debt." Under the compromise the Treasury agreed to issue a new series of long-term, non-marketable 2¾ per cent bonds in exchange for an outstanding series of marketable 2½ per cent bonds. A few days later, the Fed lowered its support price for "governments."

The years since the 1951 accord have seen the return of a money market in which interest rates tend to rise and fall in response to the pressures of supply and demand. The Federal Reserve cooperates with the Treasury, but it does not guarantee the price of government securities, and they have risen and fallen in company with the rest of the market.[18] During the Eisenhower administration's first four years, relations between the Federal Reserve and the Treasury were generally harmonious, but evidence of at least one disagreement has come to light.

At the time the discount rate was raised last April, the Federal Reserve was concerned about the inflationary aspects of a sharp increase in the amount of short-term borrowing to finance plant and equipment expansion while administration officials were worried about the deflationary aspects of a decline in automobile sales and housing starts. It was widely reported, a short time after the advance in the discount rate, that doubts about the wisdom of that action had been expressed by Treasury Secretary Humphrey, Commerce Secretary Weeks and Labor Secretary Mitchell, as well as by Chairman Arthur Burns of the President's Council of Economic Advisers. Humphrey informed the Senate Finance Committee the next month that if it had been his responsibility, he would "not have made this last

[18] Banks have lately been forced to sell large quantities of U.S. securities to meet the surge of demands for credit, incurring substantial losses in the process.

move." "This last one might have been postponed, and natural conditions might have taken care of it."

President Eisenhower, however, stressed the independence of the Federal Reserve and expressed confidence that it would not allow money to get too tight.[19] After the discount rate was raised again in August, there were reports that that increase also had been opposed by administration officials, but in recent months there has been abundant evidence that Federal Reserve policies now enjoy the full backing of the administration.

Monetary Policy for a Diverse Economy

AIRING of divergent views on the wisdom of the Federal Reserve's tight credit policy has brought increased questioning of the effectiveness of monetary devices in controlling the forces that lead to inflation or deflation. Even the warmest defenders of monetary measures admit that they do not afford a sovereign remedy for all ills that may afflict the economy.

Elliott Bell recently asserted that the limitations of overall credit control were "becoming more and more apparent."

> It is often said that . . . quantitative credit control is the fairest kind of control. . . . Actually, in today's circumstances, overall credit restriction bears down very hard on some segments of the economy while it does not at all affect others. . . . So it turns out that . . . [it] is in practice highly selective—or at least discriminatory.
>
> This is not at all to depreciate the usefulness of general credit control. . . . But is it the proper medicine for every pain or pimple in the national economy? I question whether you can keep the Steel Workers Union from seeking and obtaining higher wages by tightening credit. I doubt [that] you can directly affect instalment credit by forcing up the prime rate a few notches. Nor can you keep big corporations from carrying out the capital expansion plans they have made simply by raising interest rates.[20]

"The truth is," Bell concluded, "overall credit control alone is a pretty crude weapon to use in dealing with an economy

[19] At press conferences on Apr. 25 and May 4, 1956. F.R.B. Chairman Martin told an Atlantic City audience on May 4 that rising interest rates did not signal a policy of "choking off the flow of credit and forcing rates artificially higher, for there is not any such policy and there is not going to be one of that kind."

[20] Address before American Bankers Association, Los Angeles, Oct. 22, 1955.

where not all elements are expanding and not all lines of business need to be discouraged."

C. Canby Balderston, vice chairman of the Federal Reserve Board, observed in a Philadelphia address last Oct. 12 that the problem of protecting the purchasing power of the dollar was "like a three-legged stool." It required the "combined action of general monetary policy, . . . fiscal policy, and . . . prudent decision-making by labor leaders, business executives, and consumers." The problem of chosing the proper controls is complicated by the fact that the nation is at peace, and there is "no place," according to Secretary Humphrey, for "wartime controls or powers to ration work and materials . . . to dictate wages, prices, or rents." [21]

Both critics and defenders of the Federal Reserve Board's policy of restraint have raised the question whether general monetary controls might not be supplemented or replaced by selective credit controls, such as those formerly applied to instalment buying and real estate transactions.[22] Sen. J. William Fulbright (D-Ark.), chairman of the Senate Banking Committee, said, Dec. 16, that there was "justification for the Board's tight money policy," but that if high interest rates caused hardship, "direct methods of controlling credit, such as consumer credit curbs, may be warranted."

Proposals for Re-inspection of Credit Machinery

The widening debate over the best means of assuring economic stability and growth has brought forth a steadily growing number of calls for an authoritative review of the nation's monetary policies and a re-inspection of the machinery for carrying them into effect. An early proposal that seems to have stimulated many more recent ones was advanced last spring by Allan Sproul, then president of the New York Federal Reserve Bank.

Speaking before the New Jersey Bankers Association at Atlantic City on May 24, Sproul urged appointment of a presidential commission, modeled on the Randall Commis-

[21] Address before Detroit Economic Club, Oct. 9, 1956.

[22] Regulation W, which controlled instalment credit, was last in effect between Sept. 18, 1950, and May 7, 1952. Regulation X, which restricted real estate credit, was in operation from Oct. 12, 1950, to Sept. 16, 1952. The only selective control exercised at the present time is Federal Reserve regulation of margin requirements on stock market transactions.

sion on Foreign Economic Policy, to conduct a broad inquiry into the workings of the money and banking system. "We cannot afford much longer," he said, "to go ahead not really knowing what to expect of our central banking system, of our commercial banking system, of our savings banks and building and loan associations, of our insurance companies and pension trusts, and of all the other bits and pieces which we are using to keep our production facilities and our credit facilities in balance."

Robert H. Craft, newly elected president of the Investment Bankers Association, addressing the association's convention at Hollywood, Fla., Nov. 29, directed attention to the fact that there had been no comprehensive survey of U.S. monetary problems since the Aldrich Commission carried out the study (between 1908 and 1912) that culminated in establishment of the Federal Reserve System. Rep. Patman agreed, Dec. 10, that such a study was past due, but he thought it should be made by a joint congressional committee rather than an outside commission. He said Congress had "an inescapable constitutional responsibility" in this field.

When Elliott Bell testified before the Patman subcommittee last month, he suggested that a commission reviewing monetary policy might examine, among other things, the adequacy of the Federal Reserve, the relationship between the Fed and other government agencies, and Reserve "responsibilities toward the government securities market." Some observers saw hints in those and other recent suggestions of a new effort to put the Federal Reserve back under Treasury domination, but Bell has denied any such implications.

Advocacy of Top-Level Economic Coordinating Group

Believers in Treasury-central bank separation have scented a special threat to Federal Reserve independence in Bell's suggestion that a national economic council be set up to fix and coordinate basic economic policies of the government. In an address before the American Bankers Association at Los Angeles last Oct. 22, Bell asserted that the United States was the only country in the world today in which the central bank could legally "tell the head of its government to go fly a kite." If the government is to be held responsible for economic stabilization, he declared,

there must be "a chain of responsibility reaching through the presidency to all the instrumentalities that do the stabilizing."

The coordinating body proposed by Bell would be composed of the Secretary of the Treasury, the chairman of the Federal Reserve Board (on an equal footing), the chairman of the President's Council of Economic Advisers, and other top-ranking economic policy makers in the government. The President himself would be chairman and would resolve any conflicts between different agencies.

Bell said that such a plan would "preserve the independence of the Federal Reserve System," but would "give the administration the power to help determine those basic economic and monetary policies for which it must, in any case, take full political responsibility." Opponents of Bell's proposal for a national economic council profess to see a dangerous similarity between it and a recommendation made in 1952 by Treasury Secretary Snyder for creation of a "small consultative and discussion group" to advise the President and "achieve accord before discord arises."

Many experts have deplored the lack of an overall economic coordinating agency. They have criticized the absence of a single authority that could harmonize monetary and fiscal policies, and coordinate national spending and financing programs. However, Under Secretary of the Treasury Burgess stated before the American Bankers Association, Oct. 23, that such an agency was not needed. He maintained that the Advisory Board on Economic Growth and Stability, headed by (then) Chairman Burns of the Council of Economic Advisers, already gave the government "a means of bringing together all its efforts" in national economic matters.[23]

Chairman Martin of the Federal Reserve Board stated before the Patman subcommittee last June 12 that "Hesitancy and delay in taking monetary action might result if those responsible for action were expected to explain publicly and defend any given step of a continuing or changing pattern." The final decisions of the Federal Reserve, he said, "must be . . . [its] own and represent, as closely as human relations can, . . . [its] judgment on the direction of action that will contribute most to the public welfare."

[23] The board consists of representatives of the Departments of Agriculture, Commerce, Labor, State, and Treasury, the Federal Reserve, the Budget Bureau, and the President.